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IN THE
Supreme Court of the United States
OCTOBER TERM 2000

VERIZON COMMUNICATIONS INC., ET. AL,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES OF AMERICA
Respondent.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF RESPONDENTS PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK AND NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS ON THE MERITS

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August 6, 2001

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QUESTION PRESENTED

Whether a regulated utility can claim a 5th Amendment unlawful confiscation from an agency's use of a forward-looking methodology where that utility fails to demonstrate the challenged order will have a significant adverse impact on its financial condition?

LIST OF PARTIES BELOW AND RULE 29.6 CERTIFICATION

Pursuant to U.S. Sup.Ct. Rule 29.6, 28 U.S.C.A., Respondents state as follows:

The New York Public Service Commission is the State governmental body charged by law with responsibility for setting rates and ensuring that adequate service is provided by New York's public utilities. As a public utility commission it does not need to file a corporate disclosure statement.

The National Association of Regulatory Utility Commissioners ("NARUC") is supported predominantly by dues paid by its State public utility commission members and through revenues generated by three meetings each year of those members. NARUC has no parent company, subsidiary, or affiliate.

The Parties to the proceeding before the 8th Circuit follow: Airtouch Communications, Inc., Alabama Public Service Commission, Association For Local Telecommunications Service, AT&T Corporation, Bell Atlantic Corporation, Bellsouth Corporation, California Public Service Commission, Competitive Telecommunications Association, Cable & Wireless Company, Colorado Attorney General's Office, Federal Communications Commission, Georgia Consumers' Utility Counsel Division, GTE Service Corporation, Iowa Utilities Board, Kentucky Public Service Commission, Massachusetts Department of Telecommunications and Energy, Maryland Public Service Commission, Mississippi Public Service Commission , Montana Public Service Commission, New York State Department of Public Service, National Association Of State Utility Consumer Advocates, National Telephone

LIST OF PARTIES BELOW (CONTINUED)

Cooperative Association, North Carolina Utilities Commission, National Association of Regulatory Utility Commissioners, SBC Communications, Inc., Organization For The Protection And Advancement Of Small Telephone Companies, Oregon Dept. Of Justice, Pennsylvania Public Utility Commission, South Dakota Public Service Commission , Southwestern Bell Telephone, Southern New England Telecommunications Corporation, Texas Office Of Public Utility Counsel, Texas Attorney General, United States Telephone Association, Wisconsin Public Service Commission, US West, Inc., United States Of America, Verizon Services Group, Virginia State Corporation Commission.

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BRIEF OF RESPONDENTS PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK AND NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

INTRODUCTION

The National Association of Regulatory Utility Commissioners ("NARUC") is a quasi-governmental nonprofit organization founded in 1889. NARUC represents those government officials in the fifty States, the District of Columbia, Puerto Rico, and the Virgin Islands, charged with the duty of regulating, *inter alia*, the telecommunications common carriers within their respective borders. [1]

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[1] Both the United States Congress and federal courts have recognized that NARUC is a proper party to represent the collective interest

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NARUC's State commission members, including co-respondent the Public Service Commission of the State of New York, strongly oppose the arguments presented by incumbent Local Exchange Carrier (ILEC) petitioners Verizon Entities, BellSouth Corporation, SBC Communications Inc. and the United States Telecom Association (*hereinafter* "ILECs" or "Petitioners") for review. A Supreme Court decision upholding ILECs' confiscation claims on the basis of Petitioners' flawed analysis of the statutory text and related Constitutional provisions would ignore both the history of regulation and this Court's precedent on takings issues. It also would have an obvious adverse impact across the range of State and

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of the State regulatory commissions. See, e.g., 47 U.S.C. § 410 (1986), where Congress calls NARUC "the national organization of the State commissions" responsible for economic and safety regulation of the intrastate operation of carriers and utilities. Cf, 47 U.S.C. § 254 (1996) (J.A. 29). See, also, *USA v. Southern Motor Carrier Rate Conference, et al.*, 467 F.Supp. 471 (N.D. Ga. 1979), aff. 672 F.2d 469 (5th Cir. Unit "B" 1982); aff. en banc, 702 F.2d 532 (5th Cir. Unit "B" 1983, rev'd, 471 U.S. 48 (1985). See, also *Indianapolis Power and Light Co. v. ICC*, 587 F.2d 1098 (7th Cir. 1982); *Washington Utilities and Transportation Commission v. FCC*, 513 F.2d 1142 (9th Cir. 1976). NARUC is a party to this proceeding. NARUC filed the first appeal of the FCC order that is the basis of the 8th Circuit decision on review and participated in this Court's first review (and reversal) of the 8th Circuit's determinations on State commission authority issues. Subsequently, after the 8th Circuit issued the decision up for review in this proceeding (partially vacating the FCC pricing methodology), NARUC also filed with the 8th Circuit supporting the FCC's request for a stay of mandate pending the FCC's petition for a writ of certorari.

Federal energy, water, and telecommunications utility regulation that has for years relied on forward-looking cost methodologies. As outlined in more detail *infra*, this Court's decisions in *FPC v. Hope Natural Gas Co. ("Hope")*, 320 U.S. 591, 602 (1944), as later affirmed by *Duquesne Light Co. v. Barasch ("Duquesne")*, 488 U.S. 299, 307, 102 L. Ed. 2d 646, 109 S. Ct. 609 (1989), has made modern utility regulation possible by providing regulators with great flexibility to try different methods as long as the overall process and outcome are reasonable. Petitioners have provided no reason for this Court to undercut that flexibility.

OPINIONS AND ORDERS BELOW

The opinion of the Eighth Circuit Court of Appeals is reported at *Iowa Utilities Board, et al. v. Federal Communications Commission and the United States of America*, 219 F.3d 744 (8th Cir. 2000) ("*Iowa III*"). That decision reviews the Federal Communications Commission's "First Report and Order", *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 F.C.C.R. 15499 (1996) (J.A., 500) ("*Local Competition Order*") and the accompanying regulations codified at 47 C.F.R. §§ 51.1-51.809. The relevant regulations are reprinted in Petitioners' brief ("ILEC Brief") appendix at pages 28a –34a.

JURISDICTION

This Court has jurisdiction of this matter pursuant to 28 U.S.C. § 1254(1).

RELEVANT CONSTITUTIONAL PROVISIONS AND STATUTES

This matter involves the Takings Clause of the Fifth Amendment to the United States Constitution, U.S. Const. amend. V; and the *Communications Act of 1934*, as amended by the *Telecommunications Act of 1996*, 47 U.S.C. § 151 *et seq.*, Pub.L. No. 101-104, 110 Stat. 56 (1996) (West Supp. 1998).

STATEMENT OF THE CASE

The ILECs have petitioned for review of the Eighth Circuit Court of Appeals decision in the matter of *Iowa Utilities Board, et al. v. Federal Communications Commission and the United States of America*, 219 F.3d 744 (8th Cir. 2000)("*Iowa III*"). The *Iowa III* case disposed of challenges to a Federal Communications Commission ("FCC" or "Commission") order outlining, *inter alia*, pricing standards for NARUC's member commissions to use in arbitrations under Section 252 of the Telecommunications Act of 1996 ("Telecom Act" or "Act"). See *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report & Order, 11 F.C.C.R. 15499 (J.A., 500) ("*Local Competition Order*").

Sections 251 and 252 of the Telecom Act outline certain obligations for incumbent local exchange carriers ("ILECs") as part of the Act's effort to open up local phone markets to competition. Section 251 requires the ILECs to allow their competitors, competitive local exchange carriers ("CLECs"), to interconnect with their network and use those

facilities to provide competing local phone service. *See*, 47 U.S.C. § 251. Such interconnection must be at least equal in quality to that provided by the ILEC to itself or to any other party to which the carrier provides interconnection at rates, terms and conditions that are just, reasonable and nondiscriminatory. 47 U.S.C. § 251(c)(2). ILECs must also provide such access to individual network elements on an unbundled basis at rates, terms and conditions that are just, reasonable and nondiscriminatory. 47 U.S.C. § 251(c)(3).

In Section 252, Congress articulated procedures for negotiating, arbitrating and approving the interconnection agreements as well as the rates for unbundled elements. Specifically, § 252 provides that rates for interconnection of facilities and unbundled elements required in § 251 shall be just and reasonable and based on the cost (determined without reference to a rate of return or other rate-based proceeding) of providing the interconnection or network element. 47 U.S.C. § 252(d)(1). The section also requires the rates to be nondiscriminatory and allows inclusion of "reasonable profit." The FCC's *Local Competition Order* adopted initial rules designed to implement §§ 251 and 252. *Local Competition Order* at 15507 (J.A., 268). Included in those rules were provisions outlining the pricing methodologies States must use to set prices for interconnection under § 252 if the ILEC and CLEC cannot reach their own agreement. *Id.* at 15812 (J.A. 325-7). The order establishes a forward-looking cost methodology known as Total Element Long Run Incremental Cost ("TELRIC") that sets prices of interconnection and access to unbundled

elements based on forward-looking, economic costs that best replicate, to the extent possible, the conditions of a competitive market. *Id.* at 15846 (J.A. 379-380).

Petitioners argue the FCC's forward-looking pricing methodology, *inter alia*, will not allow the company to recover all the costs it incurs meeting its interconnection obligations. ILEC Brief at 28. Petitioners contend the FCC's TELRIC rules devalue the existing network and undercompensate carriers for the network elements they are compelled to provide to CLECs under the Telecom Act. *Id.*

This is the second time this Court has accepted a writ to review an 8th Circuit decision addressing the FCC's *Local Competition Order*. In *AT&T Corp v. Iowa Utils. Bd.*, 525 U.S. 366 (1999) ("*Iowa II*"), this Court affirmed in part, reversed in part, and remanded the 8th Circuit's original decision, *Iowa Utils. Bd. v. F.C.C.*, 120 F.3d 753 (8th Cir. 1997) *("Iowa I")*, vacating, in part, rules established in the *Local Competition Order*. *See*, *Iowa III*. At that time, this Court, *inter alia*, reversed the portion of the 8th Circuit's opinion pertaining to State commission authority and held that the FCC had jurisdiction to design a pricing methodology. *Id.* at 748. On remand, the 8th Circuit reviewed the merits of the FCC's forward-looking pricing methodology, proxy prices and wholesale pricing provisions. *Id.* Petitioners petitioned for review of that decision, *inter alia*, generically challenging the constitutional validity of TELRIC as a pricing methodology.

Respondents submit this Brief in opposition to the ILECs. In particular, Respondents urge this Court to reject arguments that the order below is confiscatory or violates the Takings Clause of the Fifth Amendment to the United States Constitution.

SUMMARY OF ARGUMENT

Petitioners misconstrue § 252(d)(1), insisting that ratemaking is traditionally a retrospective exercise, designed to allow utilities to recover "historical cost" and that the FCC's forward-looking TELRIC methodology used to set rates is, therefore, *ultra vires* and irrational. This construction is not supported by either the history of regulation generally or the specific language of the statute. Ratemaking is inherently a prospective, forward-looking exercise and State commissions have historically utilized forward-looking cost methodologies in setting rates. Additionally, Petitioners cannot claim an unconstitutional confiscation simply based on the allegation that the FCC chose the wrong methodology. The method employed to arrive at the rates of the utility is not determinative. If the total effect of the rate order is not unreasonable, i.e., it does not jeopardize the Petitioners' financial integrity, this Court's prior decisions indicate there is no regulatory takings claim. Neither Petitioners' brief, nor the record in this proceeding, includes sufficient evidence to support a claim that the FCC's orders result in an uncompensated taking under the 5th Amendment.

ARGUMENT

PETITIONER'S STATUTORY AND CONSTITUTIONAL CRITICISMS OF PRICES BASED ON FORWARD-LOOKING PRICING METHODOLOGIES LACK SUBSTANCE.

Petitioners contend the FCC's rules requiring States to base incumbent local exchange companies' charges to competitors on the incumbents' total element long-run incremental costs ("TELRIC") are inconsistent with § 252(d)(1) of the Communications Act (ILEC Brief 19-23) and violate the Fifth Amendment's prohibition against government confiscation of private property (ILEC Brief 23-44). As discussed, *infra*, the Petitioners' reading of § 252(d)(1) is simply incorrect. Moreover, their constitutional arguments are at best premature, misconstrue existing precedent, and lack record support.

A. PETITIONERS' READING OF § 252(d)(1) IS INCORRECT

This Court recently specified the 1996 Act delegates to the FCC the task of establishing a rate-setting methodology to advance the Act's goal of transforming the monopoly rate-of-return regime for local telephone service into a competitive market. Ignoring the implications of this Court's findings,[2] the ILECs argue that § 252(d)(1)'s use of

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2 See *AT&T Corp. v. Iowa Utils. Bd.* ("*Iowa I*"), 525 U.S. at 397, 405; *Id.* at 423 (Sep. opinion of Breyer, J.) ("The statute sets forth those

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the word "costs" must necessarily be equated with "historical costs" based on either a "plain reading" of the statute or the allegation that "the term {"cost"} has acquired a fixed meaning in that context." ILEC Brief at 20. Neither rationale is convincing. The federal court decisions[3] consistently rejecting arguments that the States' widespread adoption of forward-looking costing methodologies violated the 1996 Act undermines any suggestion that the "plain meaning" of the section rigidly specifies reference only to "historical" cost. Indeed, the courts have routinely recognized that a statutory requirement of cost-based rates does not prescribe any specific measure of cost.[4]

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standards in general terms, using such words as, "based on ... cost," "nondiscriminatory," and "just and reasonable." Terms such as these give rate-setting commissions broad methodological leeway; they say little about the "method employed" to determine a particular rate"). Cf *GTE v. Morrison*, 6 F.Supp.2d 517, 529 (E.D. Va. 1998) ("Historical costs are determined in a rate-of-return or other rate based proceeding. . Therefore, they are excluded by § 252(d)(1)(A).")

3 See footnote 14, *infra*.

4 See, e.g., *Strickland v. Commissioner, Maine Dep't of Human Resources*, 48 F.3d 12, 19 (1st Cir. 1995) ("[T]he word 'cost' is a chameleon."); *Strickland v. Commissioner, Maine Dep't of Human Resources*, 96 F3d 542, 546 (1st Cir. 1996) (there is "ambiguity inherent in the word 'cost,'" and absent explicit congressional guidance, courts cannot conclude. . .Congress has "spoken directly"; *Appalachian Power co. v. EPA*, 135 F.3d 791, 809 (D.C. Cir. 1998) (noting "essential ambiguity of the word" cost); *Alabama Elec. Coop. Inc. v. FERC*, 684 F2d 20, 27 (D.C. Cir. 1982); Cf.. Siegel, Joel G., *Dictionary of Accounting Terms, 3rd Ed* (term "cost" is "virtually meaningless without an indication of the type of cost, such as incremental cost, variable cost,

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To support the notion that ratemaking is primarily designed to allow utilities to recover "historical cost" (ILEC Brief at 19) and that the FCC's forward-looking TELRICs are, therefore, *ultra vires* (*Id.* at 19-23) and irrational (*Id.* at 44-49), Petitioners also erroneously insist that ratemaking is traditionally a retrospective exercise.

Although there are many acceptable methods for setting utility rates (e.g., cost of service debt service; comparison to surrounding utilities), *ratemaking is essentially a prospective, forward-looking, exercise.*[5] Regulatory commissions, therefore, often design rates to recover the costs they expect a utility to incur in a future "rate year."[6] Commissions examine: (1) the revenues the company is expected to earn, at current rates; (2) the prudent[7]

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fixed cost, replacement cost or historical cost.").

5 A. Kahn, *The Economics of Regulation: Principles and Institutions*, Vol. 1, Economic Principles, p. 26 (1970).

6 See, e.g., *Statement of Policy on Test Periods in Major Rate Proceedings*, 22 PUR4th 611, 17 NY PSC 25-R (1977).

7 In a free market economy, competition forces shareholders to bear the consequences of management imprudence because the seller who attempts to recover imprudent costs in prices will lose customers. Competitive local exchange customers -- and retail ratepayers, in many areas, for that matter -- do not have the luxury of taking their business elsewhere if incumbent telephone companies charge prices that reflect wasteful practices. In order to spare consumers of monopoly services the effects of company imprudence, regulatory agencies set rates that recover

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operating expenditures the company is projected to incur during the period for which rates are being set; (3) the future rate base, or capitalization on which the company will earn a return; and (4) the rate of return that the company will need during the future period to cover the company's cost of raising capital. Once a regulatory agency establishes a company's overall revenue requirement, it develops a rate structure to recover the revenue requirement on a company-wide basis. Development of the rate structure begins with an allocation of the revenue requirement to the various services that the company offers. Next, the Commission designs rates for each service relying not only on projected costs, but on factors such as "the value of service to a class of customers,"[8] minimization of rate impacts and other factors.[9]

Thus, each service may or may not support its precise share of the revenue requirement. The Petitioners' claim that traditional ratemaking is retrospective and that Congress necessarily intended wholesale rates set under § 252 to recover historic costs is simply incorrect.

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prospectively only costs that are prudent. See, e.g., *Niagara Mohawk Power Corp. v. Public Serv. Comm'n*, 69 N.Y.2d 365 (1987).

8 See, e.g., *MCI Telecommunications Corp. v. Public Serv. Comm'n*, 108 A.D.2d 285, 295 (3rd Dep't 1985), appeal withdrawn, 66 N.Y.2d 760 (1985).

9 *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).

In an effort to buttress this argument, the ILECs argue that TELRIC, (and, necessarily by implication, the use of forward-looking costing methodologies generally), are "unmanageable" or "unworkable."[10] Again, this argument ignores the facts. Even before the 1996 Telecommunications Act, State and Federal regulators found that the best regulatory policy initiatives, in a variety of contexts, require the use of forward-looking costs. For example, the Interstate Commerce Commission, and its successor, the Surface Transportation Board, regulated railroad rates on the basis of forward-looking costs.[11] Similarly, California, Oregon, New York and others were initiating policies that required the use of forward-looking costs well before the Act's passage in 1996.[12]

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10 See ILEC Brief at 45-46.

11 See, e.g., *West Texas Util. Co. v. Burlington* N.R.R., Docket No. 41191 (Surface Trans. Bd. May 3, 1996), aff'd, *Burlington N.R.R. v. Surface Transp. Bd.*, 114 F.3d 206 (D.C. Cir. 1997).

12 See, e.g., California's pre-Telecom Act "Interim Opinion Adopting Cost Methodology Principles and a List of Basic Network Functions for Which Cost Studies Are to Be Perform", *In re: Open Access to Bottleneck Services and a Framework for Network Architecture Development of Dominant Carrier Networks*, Decision 95-1-016, 62 CPUC 2nd 575, at 610 (December 6, 1995), adopting as a principle:

> "LRIC studies should be "forward-looking;" i.e., they should not reflect a company's embedded base of facilities. Rather the study should account

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After the 1996 legislation, this Court required NARUC's member State commissions to set prices in arbitrations under 47 U.S.C. § 252 of the Act in a manner that is not inconsistent with the FCC's stated forward-looking methodology.[13] Even before this Court acted, the State commissions, given the standard set out in § 252, basically followed a forward-looking pricing standard in the arbitrations required under the Act. Indeed, one treatise notes that, even "[w]hile the *Iowa Utilities Board* case was being litigated, most States used their price-setting authority in ways closely following the FCC models." .[14]

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for only the most efficient and cost-effective means of providing the service."

13 See *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999); See also *Iowa Utilities Board, et al v. FCC*, 219 F. 3rd 744, 757 (8th Cir 2000), where the 8th Circuit agrees that the FCC's role is to "resolve general methodological issues," and "it is the State commission's role to exercise its discretion in establishing rates."

14 See Huber, Peter W., Kellogg, Michael K., and Thorne, John, *Federal Telecommunications Law*, § 2.4.4.1, at 185 (2d ed. 1999). During that same period, federal courts consistently rejected arguments that the States' widespread adoption of forward-looking costing methodologies violated the 1996 Act. See, e.g., *GTE South Inc. v. Morrison*, 6 F. Supp. 2d 517, 528-30 (E.D. Va. 1998), aff'd on other grounds, 199 F.3d 733, 742-44, 749 (4th Cir. 1999); see also *Bell Atlantic-Delaware, Inc. v. McMahon*, 80 F. Supp. 2d 218, 235-36 (D. Del. 2000). This trend has continued. See, e.g. "Order Granting Southwestern Bell Telephone Company's Petition for Reconsideration of Order on Reconsideration/Clarification Date June 23, 2000" *In the Matter*

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A Supreme Court decision upholding ILECs' confiscation claims on the basis of Petitioners' flawed analysis of the statutory text ignores both history and this Court's precedent. It also would have an obvious adverse impact across the range of State and Federal energy, water, and telecommunications utility regulation that has for years relied on forward-looking cost methodologies. As outlined in more detail *infra*, this Court's decisions in *FPC v. Hope Natural Gas Co. ("Hope")*, 320 U.S. 591, 602 (1944), as later affirmed by *Duquesne Light Co. v. Barasch ("Duquesne")*, 488 U.S. 299, 307, 102 L. Ed. 2d 646, 109 S. Ct. 609 (1989), has made modern utility regulation possible by providing regulators with great flexibility to try different methods as long as the overall process and outcome are reasonable. Petitioners have provided no reason for this Court to undercut that flexibility.

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of the Joint Application of Sprint Communications Company L.P. et al. for the Commission to Open a Generic Proceeding on Southwestern Bell Telephone Company's Rates for Interconnection, Unbundled Elements, Transport and Termination, and Resale, Docket No. 97-SCCC-149-GIT (July 27, 2000), Slip Opinion at page 4, where the Kansas Corporation notes it has ". . .consistently applied TELRIC principles" which it believes best estimates "the costs a forward-looking, efficient competitor would incur." That decision can be downloaded from http://www.kcc.state.ks.us/.

B. PETITIONERS' TAKING ARGUMENTS ARE PREMATURE.

Where a party alleges a governmental taking of its property, but that property has not been taken and, depending on a complex series of future governmental actions (e.g., rate design) may never be taken, the case is not ripe for judicial review.[15] The Petitioners contend that the Fifth Amendment requires that the rates set by the FCC for regulated services be designed to generate future revenues that will, in the aggregate, cover incumbents' prudent historic costs for all regulated services.[16] They do not, however, demonstrate that aggregated revenues *from wholesale services and interstate access charges* fail to cover total prudent costs allocable to those services. Indeed, there is nothing in the record presented for review sufficient to support a claim either that

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15 See, e.g., *Long Island Lighting Co v. Cuomo*, 666 F. Supp. 370 (N.D.N.Y. 1987). Under traditional "takings" jurisprudence, the Court must engage in "essentially ad hoc, factual inquiries" that address, e.g., the specific economic impact of the regulation; and the extent to which the regulation has interfered with investor-backed expectations. *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978). "A court cannot determine whether a regulation has gone 'too far' unless it knows how far the regulation goes." *MacDonald, Sommer & Frates v. Yolo County*, 477 U.S. 340, 348 (1986).

16 ILEC Brief at 17-19. The States do not agree that companies are entitled to rates that necessarily cover all costs (see discussion, *infra*). We do, however, concur with the observation that the FCC cannot look to intrastate revenues to meet the constitutional standard for "just and reasonable" interstate rates. See generally *Smith v. Illinois Bell Telephone Co.*, 282 U.S. 133 (1930).

Petitioners will fail to receive a return on prudent investment or that there will be significant stranded costs.[17] Petitioners urge this Court to ignore the absence of record evidence solely on the basis of untested extra record assertions that TELRIC will inevitably result in massive discounts from historical costs.

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17 Other than limited excerpts from Petitioners' personnel, the only "evidence" referenced are extra record statements that the ILEC's network is worth $342 billion, and that TELRIC's valuation of $180 billion is low. ILEC Br. at 10-11. But the $342 billion cited is the *undepreciated* cost. Based on the same data set, net of depreciation, the "value" of the incumbents network is $166 billion. *See* 1999 Statistics of Communications Common Carriers, at Table 2.9 (Account 350) (rel. Aug. 11, 2000), URL: http://www.fcc.gov/bureaus/common-carrier/reports/fccstate_link/socc/99s0cc.pdf. Moreover, that depreciated $166 billion is strictly an embedded or historical cost figure. It does not reflect any review of the "prudence" of costs incurred. See note 4, *supra*.

Inasmuch as further factual development is required before one can even pass judgment on the Petitioners' alleged standard for confiscation, the Petitioners' claim that TELRIC rates result in a taking of their property is speculative and, therefore, premature.[18]

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18 Indeed, there is public data indicating that the FCC's forward-looking methodology has not resulted in financial losses for ILECs. In a review of a treatise on ILEC takings issues, Professor Trebing observes

> "If investors perceive that the confiscation of assets is taking place, this will be reflected in the {ILEC} stock prices. . .Such an examination reveals no across-the-board price decline . . .On the contrary, stock prices have moved significantly higher over the past decade demonstrating general investor confidence."

Trebing notes the traditional regulatory criterion for judging a reasonable level of profit was a market-to-book ratio of 1.05-1.10. Between 1969-1978, AT&T's M/B ratio was 1.05. (The most recent M/B ratios cited for ILECs show in June 1999 GTE with an M/B of 6.91, Ameritech - 6.34, Bell Atlantic - 7.14, BellSouth - 6.40, and SBC - 6.97). AT&T shows an M/B of 3.95 for the same period. Trebing says: "Whether these increases are attributable to the prospect of oligopoly profits . . .can be debated, *but they do not reflect the burden of stranded and uncompensated costs on the performance of the firm.*" Trebing, Harry, *Review of "Deregulatory Takings and the Regulatory Contract", Telecommunications Policy*, 24 (Pergamon 2000) at 161-7. {Emphasis Added.} *Compare*, Gabel & Rosenblum, *Who's Taking Whom: Some Comments and Evidence on the Constitutionality of TELRIC*, 52 Fed. Com. L.J. 239, 265 (March 2000), where after reviewing financial data from 150 of the largest U.S. phone

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C. PETITIONER'S CONSTITUTIONAL ARGUMENTS MISCONSTRUE EXISTING SUPREME COURT PRECEDENT.

The Constitution prohibits government from taking a citizen's property without rendering just compensation. *Regan v. Farmer's Loan and Trust Co.*, 154 U.S. 362 (1894). Regulation, of course, impedes the use of a company's property, but it is permissible, provided the company is paid "just and reasonable" rates for its service to the public. *Munn v. Illinois*, 94 U.S. 113, 126 (1877).

The constitutional floor for the "just and reasonable" standard has undergone several Supreme Court revisions. In 1894, the Court enunciated the "used and useful" doctrine, holding utilities were entitled, as a constitutional minimum, to a reasonable return on the "fair value" of property devoted to the public service; that is, "used and useful" plant.[19] This doctrine touched off decades of controversy over how

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companies, the authors conclude the majority surveyed are earning returns that are "more than sufficient" to assure the financial integrity of their enterprises, maintain credit-worthiness and attract additional capital: "Based on this data . .the {ILEC's}. .contention, that the use of the TELRIC methodology, on its face, results in a taking, is not grounded in the reality depicted by their earnings reports." While NARUC in no way suggests intrastate rates could be called on to offset any interstate revenue deficiency, a telephone utility with robust company-wide earnings should not be heard to allege confiscation.

19 *Smyth v. Ames*, 169 U.S. 466 (1898). "Fair value" was to be determined by a reference to a variety of factors, including the plant's original cost and its reproduction cost. *Id.* at 546, 547.

utilities' facilities should be valued and gave birth to a wide range of ratemaking methods designed to satisfy the "just and reasonable" standard. In 1923, Justice Brandeis suggested the focus belonged not on whether utility plant was useful, but on whether the investments made to construct such plant were prudent. *Missouri ex rel Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 290 (1923) (concurring opinion). His position became known as the "prudent investment" rule, which, with the "used and useful" doctrine and other methodologies, fueled the valuation debate for the next two decades. Finally, in 1944, the Supreme Court rendered the discussion academic when it found that regulatory agencies were not bound to use any particular method in determining either the components or the value of a utility's rate base. As the Court indicated, the Constitution offered no basis for overturning an agency's ratemaking method, if the "end result" of the Commission's action was "just and reasonable" rates. *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). Specifically, the Court declared that, for purposes of reviewing takings claims under the 5th Amendment, "it is the *result reached* not the method employed which is controlling," and that "[i]f *the total effect of the rate order* cannot be said to be unreasonable, judicial inquiry ... is at an end. *The fact that the method employed to reach that result may contain infirmities is not then important.*"[20]

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20 *Id.* at 602 (emphasis added). See also, *In re: Permian Basin Area Rate Cases*, 390 U.S. 747, 791 (1968), approving setting rates based

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The Fifth Amendment protects utilities only from regulations that are "so unjust as to be confiscatory."[21] It does not confer a constitutional right to government-subsidized profits. In *Duquesne,* this Court reaffirmed that ". . . it is not the theory but the impact of the rate order which counts." *Id.* at 310. It is not enough that a party merely speculates that a government action will cause it harm; rather, a taking must "'necessarily' result from the regulatory

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on the *average* costs of a large number of producers, which by definition could not specifically address investor interests in the capital costs of individual producers. The Court pointed out that the investor interests set forth in *Hope* remain pertinent, but "scarcely exhaust the relevant considerations."

21 *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989). According to the ILECs, *Duquesne* says when a regulator switches ratemaking methods, it must ensure the new method continues to provide compensation 'with in the constitutional range of reasonableness' as measured under the old methodology and essentially forecloses a switch in the circumstances presented. ILEC Brief at 26-28. But they misconstrue the opinion. In dicta, *Duquesne* did suggest that an agency that arbitrarily switched back and forth between methodologies in a way that required investors to bear the risk of bad investments some times while denying them the benefit of good investments at others could raise constitutional questions. *Duquesne* at 315. But that clearly is not the case presented. Indeed, *Duquesne* specifically recognizes that, "circumstances may favor the use of one ratemaking procedure over another." *Duquesne* at 316. Nor does Justice Scalia's concurrence support ILEC's position. It too confirms that the consequence of regulation, not the technique used, is the critical consideration for determining if a takings claim can be asserted. This undercuts the ILECs' appeal as it is clear they are merely challenging the FCC adoption of a forward-looking methodology, rather than the actual consequences of the use of that "technique."

actions." [22]

The *Hope* "end result" test should also be read in conjunction with this Court's subsequent decision in *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942). In *Natural Gas Pipeline*, the Court held that:

> "[t]he Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has

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22 See, *United States v. Riverside Bayview Homes*, 474 U.S. 121, 128 n.5, (1985). Compare, *Alenco Communications, Inc., et al. v. FCC*, 201 F.3d 608, 624 (5th Cir. 2000), where the 5th Circuit found rural LECs challenging FCC universal service orders failed to show a taking because they relied on mere speculation to support their claims, explaining:

> "petitioners must wait to experience the actual consequences of the Order before a court may even begin to consider whether the FCC has effected a constitutional taking. Until it is known what level of universal service funding each petitioner will receive . . . and under what circumstances the Commission will grant a waiver, we cannot seriously entertain a Takings Clause challenge."

> been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances." 315 U.S. at 586.

Moreover, the Court held that

> "regulation does not insure that the business shall produce net revenues, nor does the Constitution require that the losses of the business in one year shall be restored from future earnings by the device of capitalizing the losses and adding them to the rate base on which a fair return and depreciation allowance is to be earned ... the hazard that the property will not earn a profit remains on the company in the case of a regulated, as well as an unregulated, business." 315 U.S. at 590.

In concurring with the majority opinion, Justices Black, Douglas and Murphy added that they saw no reason why agency ratemaking should be subject to any constitutional floor.[23] Justices Black, Douglas and Murphy would have limited Supreme Court review to whether the agency's decision that rates were "just and reasonable" was supported in the record. 315 U.S. at 604-607. In deciding that issue, they emphasized that

> "a return to the company of the cost of the service might not be 'just and reasonable' to the public ... [t]he investor and consumer interests may so collide as to warrant the rate-making body concluding that a return on historical cost or prudent investment, though fair to investors, would be grossly unfair to the consumers." 315 U.S. at 607, 608.

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23 "[W]e must record our disagreement from an opinion which, although upholding the action of the Commission on these particular facts, nevertheless gives renewed vitality to a 'constitutional' doctrine which we are convinced has no support in the Constitution" 315 U.S. at 601.

In any event, the constitutional rate floor applied by the majority opinion in *Natural Gas Pipeline* included a proviso that consumer interests may preclude the recovery of prudent costs.[24]

With regard to whether rates are "just and reasonable," *Hope* concluded that rates must involve "a balancing of the investor and the consumer interests," but companies are not assured rates that cover all costs. 320 U.S. at 603.

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24 As noted in the concurring opinion, this principle was first

> "announced by this Court in *Covington & Lexington Turnpike Co. v. Sandford*, 164 U.S. 578: '[i]t cannot be said that a corporation is entitled, as of right, and without reference to the interests of the public, to realize a given per cent upon its capital stock ... [t]he public cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends'." 315 U.S. at 607, 608.

Thus, the "end result" test of Hope does not guarantee utilities either a particular ratemaking method[25] or recovery of all costs.[26] Rather, it reaffirms that regulators must balance ratepayer and shareholder interests.[27]

Since *Hope*, the courts have made it abundantly clear that utilities have no constitutional claim to rates based on any particular ratemaking method, or to the recovery of historic costs. *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968); *NEPCO Municipal Rate Committee v. Federal Energy Regulatory Comm'n*, 668 F.2d 1327 (1981).[28]

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25 "[I]t is the result reached not the method employed which is controlling" (320 U.S. at 602).

26 "[W]e stated in the *Natural Gas Pipeline Co.* case that 'regulation does not insure that the business shall produce net revenues'" (320 U.S. at 603 [quoting 315 U.S. p. 590]).

27 In *Hope*, the Circuit Court of Appeals had attempted to limit the holding in *Natural Gas Pipeline* that there was no constitutional requirement "that the owner who embarks in a wasting-asset business of limited life shall receive at the end more than he has put into it" to businesses scheduled to end on a day certain, as was the case in *Natural Gas Pipeline*. The Supreme Court rejected the Circuit Court's reasoning, noting that "that distinction is quite immaterial." 320 U.S. at 606.

28 In *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989), the Court upheld the constitutionality of a State statute prohibiting the recovery of expenditures for generating facilities that were not "used and useful" in the public service. Duquesne adds further support to the long-standing principle that it is the "end result" of ratemaking that is subject to scrutiny, not whether rates recover particular (e.g., historic) costs.

Accordingly, Petitioners' contention that the FCC's rules take the incumbents' property by raising the possibility of their being unable to recover historic costs is simply incorrect.

Moreover, as discussed *supra*, to succeed in its takings claim, the ILECs must demonstrate that the FCC's adoption of a forward-looking methodology will "jeopardize" their "financial integrity," either by "leaving them insufficient operating capital or by impeding their ability to raise future capital," or demonstrate that the funds provided "are inadequate to compensate current equity holders for the risk associated with their investments." *Duquesne*, 488 U.S. at 312. If the rate allowance permits the utility to operate successfully and to attract capital, the utility cannot claim confiscation, and the constitutional review of the rate order is at an end.[29]

Petitioners essentially claim the FCC's adoption of the TELRIC methodology is constitutionally impermissible because the agency has not determined in advance if the rates produced will result in revenues the ILECs deem to be sufficient.

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29 Compare, *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168 at 1181 n.3 (D.C. Cir. 1987).

Aside from (1) the somewhat questionable thesis that TELRIC "necessarily falls short of providing recovery of incumbents' historical costs,"[30] and (2) the inaccurate implicit assumption that utility investors are constitutionally guaranteed recovery of specific items of cost or investment, rather than overall rates set at just and reasonable levels, the ILECs have not presented any compelling evidence that demonstrates the rates produced by the FCC's use of this forward-looking methodology actually jeopardizes the financial integrity of the company.

Absent a showing by ILECs that the FCC's Order has produced overall rates that result in financial harm, Petitioners have not even met the threshold test for establishing a takings claim under prevailing Supreme Court precedent and its confiscation claims must be rejected.

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30 Certainly if history is any guide, forward-looking costing methodologies do not always produces costs lower than historic costs. See, e.g., *First Order*, 12 F.C.C. Rcd 8776, 8901 at ¶ 228 (observing that historic costs can be higher or lower than forward-looking costs). Indeed, the FCC points out in a recent order, that the most recent model incorporating a forward-looking costing methodology generates costs from some areas that exceed the incumbent local exchange carriers' book costs. *In re Federal-State Joint Board on Universal Service*, Tenth Report and Order, 14 FCC Rcd 20156, at ¶ 26, (Nov. 2, 1999) See also, *Hope*, 320 U.S. at 596-7 (forward-looking costs higher than historic costs); *Southwestern Bell Telephone Co. v. Public Serv. Comm'n of Mo.*, 262 U.S 276, 299-300 (1923). (Brandeis, J. concurring) (noting in some cases "replacement costs" are much greater than the actual cost of installation).

CONCLUSION

For the reasons set forth, *supra*, Respondents urge the Court to reject ILECs' arguments that the use of a forward-looking methodology necessarily results in an uncompensated taking under the 5th amendment.

Respectfully submitted,

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